Volume 27 | Issue 5 Article 2

1973

State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code

Hal M. Bateman

STATE SECURITIES REGISTRATION: AN UNRESOLVED DILEMMA AND A SUGGESTION FOR THE FEDERAL SECURITIES CODE

by

*Hal M. Bateman**

> And, finally, although this is a very delicate area, some thought should be given to the relations between these federal statutes and the state blue sky laws. The political difficulties here are obvious. But certainly we should not exclude this subject from consideration, because, if there is ever an opportunity to do something about it, this will be it, and surely some rationalization should be possible after thirty-five years or more of joint federal-state regulation.
>
> I would not suggest complete preemption as either desirable or remotely feasible politically, but there are things that might be considered. . . .
>
> . . . .
>
> We might at the very least think about preempting the field and making the states stay out unless they coordinate their procedure with the federal procedure, as is done under the Uniform Securities Act.[1]

The problem referred to by Professor Loss is well known to securities lawyers throughout the United States. It has produced chronic and increasing frustration and expenses for issuers involved in public securities distributions and their attorneys for more than four decades. Yet vigorous debate, which has continued since the end of World War II, has failed to produce any consensus as to how, if at all, the matter should be resolved.[2]

The problem arises essentially from the fact that, due to express nonpreemption on the federal level,[3] a public distribution of securities is subject to administrative regulation concurrently and independently on the federal level and on the state level in each state where the issue is offered. The obvious difficulties produced by this multiplicity of jurisdictions which may regulate a single distribution of corporate securities are further compounded by the fact that the "merit standard" regulatory philosophy reflected in most of the applicable state laws[4] lends itself to widely varied interpretation

* B.A., Rice University; J.D., Southern Methodist University. Professor of Law, Texas Tech University.

1 From remarks by Professor Louis Loss, the reporter for the *ALI, Federal Securities Code*, at the American Law Institute's meeting in Washington on May 22, 1969, and reprinted in Loss, *The American Law Institute's Federal Securities Code Project*, 25 Bus. Law. 27, 35-36 (1969).

2 The basic positions taken in this debate are discussed in 1 L. Loss, Securities Regulation 102-05 (2d ed. 1961) [hereinafter cited as Loss]. More detailed analysis and references will be found in part II *infra*.

3 Securities Act of 1933, § 18, 15 U.S.C. § 77r (1970).

4 The term "merit standard philosophy" is used to identify the general type of securities registration laws in effect in most states today, under which the administrative authority is vested with discretionary power to pass on the investment merits of an issue of securities proposed to be offered to the public, and to deny the right to sell the issue to the public if it is found to be without sufficient merit for public investment. The historical sources and rationale of this philosophy will be discussed later in the

from state to state and from one securities issue to another, and stands in sharp contrast to the "disclosure philosophy" reflected on the federal level in the Securities Act of 1933.[5] Thus, there are two distinct aspects to the basic problem: (1) a single corporate financing may be subject concurrently to a multiplicity of regulatory jurisdictions, and (2) those jurisdictions apply standards which reflect a fundamental difference in regulatory philosophies.

The suggestion by Professor Loss that the proposed Federal Securities Code[6] should come to grips with this regulatory dilemma and should attempt to arrive at "some rationalization" of it is indeed timely and meritorious. It is to be hoped that such a goal can be achieved. Nevertheless, the sharply divergent viewpoints expressed over the past two and one-half decades concerning the basic aspects of the problem must be resolved in order to achieve a satisfactory and feasible solution. This Article will attempt to analyze the nature and historical sources of the problem, review the various arguments advanced in the debate over its solution, and propose a new approach to a resolution of the dilemma which might be considered for inclusion in the proposed Federal Securities Code.

I. An Analysis of the Nature and Historical Sources of the Problem

A. *Economic Aspects*

An analysis of the regulatory dilemma which confronts a corporate issuer planning to make a public distribution of its securities should begin with a consideration of the economic function and significance of the distribution itself. First, from the standpoint of the corporate issuer the basic function and purpose of the public distribution of its securities is to raise new capital to finance its business activity. This is true whether the public financing is needed to make possible the launching of a new business venture based on a new discovery, invention, or other business opportunity, or whether it is needed to finance the further growth and expansion of an established, successful business enterprise, be it large or small. In this context the public securities distribution represents a vitally important alternative source of capital to finance business and industrial growth, without which the dramatic industrial growth of the United States over the past century might never have been possible. In the language of Circuit Judge Medina in *United States v. Morgan*:

text. *See* J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 15-17 (1971) [hereinafter cited as MOFSKY].

[5] 15 U.S.C. §§ 77a-aa (1970). The term "disclosure philosophy" refers to the method of regulation of public securities offerings which requires full and effective disclosure to public investors and to the administrative authority of all information pertaining to the security offered which would be necessary to enable investors to make informed investment decisions. This philosophy does not authorize the administrative authority to deny the right to sell the security on the basis of its own determination of investment merits. The historical sources and rationale of this philosophy will be discussed later in the text. *See* 1 LOSS 121-28.

[6] The history and purposes of the Federal Securities Code project, which is currently in progress, is described in Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969).

> It would be difficult to exaggerate the importance of investment banking to the national economy. The vast industrial growth of the past fifty years has covered the United States with a network of manufacturing, processing, sales and distributing plants, the smooth functioning of which is vital to our welfare as a nation. They vary from huge corporate structures such as the great steel and automobile companies, railroads and airlines, producers of commodities and merchandise of all kinds, oil companies and public utilities, down to comparatively small manufacturing plants and stores. The variety and usefulness of these myriad enterprises defy description. They are the result of American ingenuity and the will to work unceasingly and to improve our standard of living. But adequate financing for their needs is the life blood without which many if not most of these parts of the great machine of business would cease to function in a healthy, normal fashion.[7]

This is to say that the public distribution of securities, rather than being inherently suspect, actually serves a legitimate and necessary economic and social purpose.

Second, from the standpoint of public investors, the public distribution of securities provides an important medium for individual investment in business enterprise. Individual investors may, of course, participate either in the primary distribution itself or in the trading markets which arise from and are presumed in the primary distribution. But in either case public distributions of corporate securities are essential to the creation of varied investment opportunities for individual investors throughout the United States. Through investment in publicly distributed and traded securities, individual investors may participate in the fortunes of a wide variety of business enterprises and, hopefully, may accumulate greater individual wealth. Obviously, the greater the number and variety of securities issues which are publicly distributed, the greater the number and variety of investment opportunities there will be for public investors to select among in developing their individual investment portfolios.

Thus, public securities distributions play a key role in capital formation, and in the development of economic resources and potential for both business and industrial issuers of the securities and for the members of the public who invest in them. Without this diversified financial medium the capital resources of business would be constricted and individual investors would be quite limited in the investment possibilities available to them. Neither consequence would serve the public interest.

Both aspects of public securities distributions have experienced dramatic growth in the United States over the past century. This has brought about important changes in the role of public securities distributions in corporate financial planning and in the number, experience, and characteristics of public investors in corporate securities. There has been a concurrent evolution in the size, nature, and sophistication of the public securities markets for distribution of new issues and those for trading in outstanding securities. There is, thus, considerable contrast between the corporate is-

[7] 118 F. Supp. 621, 635 (S.D.N.Y. 1953). To the same effect, see MOFSKY 5-8.

suers, the public investors, and the securities markets of today and those of an earlier generation.

Before the turn of the century most businesses, other than railroads and utilities, were capitalized through the private resources of the immediate owners, their relatives, and associates, and through the conventional channels of commercial credit.[8] Similarly, most individuals had virtually no involvement in the public securities markets and rarely invested in corporate securities. The savings of most persons were usually invested in land, saving institutions, life insurance reserves, annuities, and similar resources more familiar to them. Accordingly, the public securities markets were very limited in scope and involved relatively few corporate issuers, investors, and investment banking firms, most of whom were geographically concentrated in the northeastern United States.[9]

The era of economic expansion between 1900 and World War I actually brought about the initial development of markets for the distribution of a variety of corporate securities to the public on any significant scale. New distribution techniques were developed which laid the foundation for many later developments, and the concept of individual investment in corporate securities became more widely accepted. The principal impetus behind this development was the expanding need of many growing businesses for new sources of capital.[10] It was inevitable, however, that the same healthy economic development also opened the door for a number of fraudulent promotions, and enabled unscrupulous securities salesmen to take advantage of a relatively inexperienced and unsophisticated group of public investors.[11]

It was not, however, until World War I that the public securities distribu-

---

[8] United States v. Morgan, 118 F. Supp. 621, 636-37 (S.D.N.Y. 1953). Railroads and utilities, of course, had large capital needs which were met principally through the distribution of bond issues. Many of these bonds were distributed to the public in the post-Civil War era through direct selling campaigns following promotional techniques developed by Jay Cooke during the Civil War. MOFSKY 5-9. Indeed, Professor Mofsky traces the earliest development of widespread public securities distributions to this era. Nevertheless, prior to the turn of the century the number and variety of businesses and industries involved was very small, and only a very limited portion of the population was engaged in investment in corporate securities to any significant extent.

[9] United States v. Morgan, 118 F. Supp. 621, 636-37 (S.D.N.Y. 1953). In the course of tracing the evolution of the investment banking industry in the United States and the methods of distributing new issues of securities to the public, Judge Medina states:

> Prior to the year 1900, the large majority of industrial and business units which existed in this country were small in size and their capital needs were small; use of the corporate form was not widespread. There was no substantial and widely scattered class of persons with surplus savings who sought promising investment opportunities. A large part of the capital needed came from abroad. Securities sales operations were conducted principally by selling agents who sold on a commission basis, and more often than not it was the issuer who bore the risk of how successfully and how quickly the required funds would be obtained.

Id. at 636.

[10] Judge Medina describes the developments in this era in United States v. Morgan, 118 F. Supp. 621, 637-39 (S.D.N.Y. 1953).

[11] A classic illustration of such promotions is described in Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 206 (1908), and Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 89 N.E. 193 (1909). Comparable activities on behalf of reputable, established business under the direction of "the Money Trust" are described in L. BRANDEIS, OTHER PEOPLE'S MONEY (new ed. 1932). *See also* MOFSKY 9-10.

tion and trading markets began to develop to anything like their modern national proportions and that large numbers of the population first became actively involved in securities investments on a nationwide basis. The event which produced these developments was the Liberty Loan of 1917 to finance the war effort, which required massive selling efforts from coast to coast. Its success produced for the first time both a large new class of public investors in securities and a securities distribution and marketing mechanism of truly national dimensions.[12]

In the decade following World War I both securities distributions and the securities investing public grew rapidly and extensively, as the nation experienced an industrial and business expansion of unprecedented proportions. The economic and business growth of this period required large amounts of new capital and produced a heavy volume of new public securities distributions, which, in turn, led to steady growth in the national securities marketing mechanism and in the number and geographic dispersion of the American securities investing public.[13]

The securities market crash of 1929 and the economic depression that followed inevitably interrupted the flow of new securities distributions and the growth of the securities markets, but within a few years the capital needs of businesses forced a resumption of securities distributions,[14] and the number of public investors in corporate securities resumed its steady increase.[15]

The steady growth in public securities distributions to finance business and industrial expansion and in the number and dispersion of public investors in corporate securities has continued unabated from the end of World War II to the present time.[16] By the end of 1970 the American shareholder population had grown dramatically to 30,850,000 individuals, according to a share ownership study by the New York Stock Exchange, and in early 1972 the number of individual shareholders was estimated by the Exchange at 32,500,000.[17] According to the same study, "Financial assets of individuals in the United States reached $2,243 billion at the end of 1971, compared with $1,787 billion at the end of 1967. Of this total, $879 billion, or over 39%, was in common and preferred stock."[18] This was by far

[12] 1 Loss 114-15; United States v. Morgan, 118 F. Supp. 621, 638-41 (S.D.N.Y. 1953).

[13] Judge Medina describes these events in United States v. Morgan, 118 F. Supp. 621, 641-42 (S.D.N.Y. 1953).

[14] *See* Judge Medina's description, *id.* at 646-47.

[15] "By the end of 1939 it was estimated that between 8 and 9 million people in the United States owned corporate stock. . . . The steady increase in stock ownership has been largely a concomitant, of course, of the continuous increase in the national wealth and income." 1 Loss 115 n.8.

[16] The statistical compilation in SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS, app. II-1 (CCH ed. 1969) [hereinafter cited and referred to as the WHEAT REPORT] presents useful basic data reflecting these developments from 1920 through 1967.

[17] NEW YORK STOCK EXCHANGE, INC., 1972 FACT BOOK 47 (1972). These estimates include shareholders of investment companies but exclude beneficiaries of pension and profit-sharing plans and similar institutional holdings. The latest survey indicates a slight but insignificant decline in the number of individual shareholders by the end of 1972. The breadth of the geographic dispersion of the individual shareholders of publicly held corporations is demonstrated in the table, *id.* at 48.

[18] *Id.* at 68.

the largest single investment medium chosen by individual investors.[19] Similarly, corporate financing through the public distribution of securities had progressed to record levels in 1971, with an extraordinary rise in new issues of common and preferred stocks.[20]

Inevitably, these developments since World War I have been accompanied by a radical increase in the experience and sophistication of individual investors throughout the United States with respect to investments in corporate securities.[21] Today millions of highly literate, well educated, individual investors consume countless investment periodicals and are furnished with a wide variety of investment services by an increasingly professionalized brokerage community. Business and financial news constitutes a regular part of the nation's daily newspapers and is regularly covered by the broadcast media. The flow of relevant investment information compelled by the federal securities laws since 1933 has had a significant impact. It is therefore obvious that the individual investor of today is significantly better informed and more knowledgeable with respect to investment in securities than his ancestor of the pre-World War I era.

In summary, it is clear that today, more than ever before, public securities distributions are of major importance in American economic life and play a vital role in the financial planning and growth of corporate issuers and of individual investors alike. From the same analysis it is also clear that present day securities distributions and securities markets generally are, with few exceptions, inescapably national and interstate in character. The individual investors of today, with their greater experience, flow of information, and access to the national securities markets, are rarely involved with exclusively local securities investments. It is, therefore, appropriate to approach the legal issues involved in the regulatory dilemma which confronts corporate issuers of securities with these factors in mind.

B. *The Historical Sources of the Regulatory Pattern*

The history and dimensions of state securities regulation have been thoroughly traced and analyzed elsewhere.[22] No attempt need be made here to restate that story in full. It is pertinent to the present discussion, however, to consider a few of the principal milestones of particular relevance to the current regulatory dilemma in their historical contexts.

Today the District of Columbia and all of the states have some type of state securities regulation or "blue sky laws."[23] These involve varied combinations of antifraud provisions, broker-dealer regulation and securities

[19] *Id.* The next largest medium for investment chosen by individuals, according to this study, was time deposits and savings shares, which accounted for only $493 billion of the total financial assets of individuals.

[20] *Id.* at 66-67.

[21] *Cf.* WHEAT REPORT 46-54.

[22] 1 Loss 23-107; L. Loss & E. COWETT, BLUE SKY LAW 3-42 (1958) [hereinafter cited as Loss & COWETT]; MOFSKY 5-17.

[23] W. CARY, CASES AND MATERIALS ON CORPORATIONS 1477 (4th ed. unabridged 1969) [hereinafter cited as CARY]; MOFSKY 3 n.1. Delaware adopted a blue sky law, effective July 13, 1973. DEL. CODE ANN. tit. 6, § 7301-29 (1973). The term "blue sky law" originated with the Kansas statute of 1911. Loss & COWETT 7.

registration requirements.[24] However, securities registration requirements in one form or another are found in virtually all of the state securities laws, and in the great majority of them these requirements are predicated on the merit standard philosophy.[25] Generally, the securities registration provisions have also become the most prominent aspect of the blue sky laws, both with respect to the relative degree of emphasis placed on them by most state administrators and with respect to their relative importance to attorneys concerned with the blue sky laws,[26] and only these provisions are the subject of the present discussion.

The prevailing merit standard approach to state securities registration is generally conceded to have been introduced by the Kansas statute enacted in 1911,[27] based on the sweeping victory of the Populist Party in Kansas in 1910.[28] It is not surprising, therefore, that the Kansas statute was heavily influenced by Populist economic philosophy and took a strictly regulatory, paternalistic approach to securities registration to protect the public in the "Agrarian West" against being bled by the "Moneyed East."[29] Under this statute, except for a few specifically exempted securities, no security could be sold in Kansas until a "permit" had been obtained from the state commissioner, who was authorized to deny the "permit" if he should find that the organizational documents of the issuer or the issuer's plan of business or proposed contracts "contain any provision that is unfair, unjust, inequitable or oppressive to any class of contributors, or if he decides from his examination of its affairs that said [issuer] is not solvent and does not intend to do a fair and honest business, and in his judgment does not promise a fair return on the stocks, bonds, or other securities by it offered for sale . . . ."[30]

The shocking strictness and breadth of administrative discretion in this regulation of the flow of capital and of investment opportunities available to the public is better understood in the light of the conditions prevailing at the time of its adoption. First, there was no federal securities regulation in effect at the time.[31] Second, Populist economic philosophy generally favored strong governmental control and regulation of economic and financial resources to direct them toward the public interest.[32] Third, as outlined in

---

24 CARY 1477-81; 1 LOSS 30-63; LOSS & COWETT 17-42; MOFSKY 3 n.1.

25 CARY 1479-80; 1 LOSS 49-63; 4 *id.* 2222-38 (Supp. 1969); MOFSKY 15-17. The merit standard philosophy is briefly described in note 4 *supra.*

26 *See* MOFSKY 15-17. The securities registration provisions of the blue sky laws have undoubtedly been the principal source of controversy and debate.

27 Ch. 133, [1911] Kan. Laws 210.

28 1 LOSS 27; LOSS & COWETT 7; MOFSKY 10.

29 1 LOSS 27; LOSS & COWETT 7-10. *See also* MOFSKY 10-11.

30 Ch. 133, § 5, [1911] Kan. Laws 212; 1 LOSS 27.

31 Federal securities regulation began with the Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1970).

32 The Populist Party arose out of the economic distress of farmers in the West and South at a time when Eastern financial interests were prospering following the 1873 panic. Consequently, much of its focus was on economic and financial issues. For example, the platform adopted at the 1892 convention in Omaha, Nebraska, favored governmental ownership and operation of the railroads and the telephone and telegraph systems, recovery by the government of land given to the railroads, a revision of the banking system and a graduated income tax, in addition to free coinage of silver and an ample supply of paper money. *See generally* J. HICKS, THE POPULIST REVOLT

the foregoing discussion, American capital markets and public securities distributors were in their relative infancy, particularly outside the northeastern United States. The public generally was neither well informed nor experienced in the matter of securities investments to any significant degree. Most of the population was agrarian, modestly educated, and easy prey to unscrupulous promoters and securities salesmen, who were essentially unregulated and unrestrained by any effective professional standards. Thus, conditions were ripe for legislative reform to protect the public from overreaching by promoters and securities salesmen, and the financial turbulence precipitated by the panic of 1907 provided the catalyst, while Populist economic philosophy directed the substantive nature of that reform.[33] In the words of one sympathetic commentator at the time:

> The state of Kansas, most wonderfully prolific and rich in farming products, has a large proportion of agriculturists not versed in ordinary business methods. The State was the happy hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as the blue sky merchants and the legislation intended to prevent their frauds was called Blue Sky Law.[34]

This is to say, then, that both the fact and the substantive nature of the securities registration law adopted by Kansas in 1911 were to a large extent historically conditioned by the circumstances prevailing in Kansas at that time.

It is not surprising that within two years twenty-three other states, most of which, like Kansas, were predominantly agrarian and had Populist leanings, adopted statutes which in most cases were based directly on the Kansas Blue Sky Law.[35] But Washington and Oregon in the Pacific Northwest and most Eastern states refused to follow at that time.[36]

Constitutional uncertainties were ultimately resolved by the Supreme Court in favor of these laws in 1917. The Court held, in a group of cases relating to the laws of three states, that in the absence of congressional legislation on the subject, the statutes did not impose an unreasonable restraint on interstate commerce, were a valid exercise of the police power of the states, and did not violate the Fourteenth Amendment.[37] Again, however, consideration of historical context of these cases is relevant. 1917

(1931, rev. 1961); R. HOFSTADTER, THE AGE OF REFORM (1955); F. MCVEY, THE POPULIST MOVEMENT (1931).

[33] 1 LOSS 7; MOFSKY 9-10; *cf.* Hall v. Geiger-Jones Co., 242 U.S. 539, 550-51 (1917). On the 1907 panic and subsequent financial turbulence, see D. DEWEY, FINANCIAL HISTORY OF THE UNITED STATES 481-94 (12th ed. 1968); M. MYERS, A FINANCIAL HISTORY OF THE UNITED STATES 245-69 (1970).

[34] LOSS & COWETT 7 n.22, quoting Mulvey, *Blue Sky Law*, 36 CAN. L.T. 37 (1916).

[35] LOSS & COWETT 10. These were Arizona, Arkansas, California, Connecticut, Florida, Georgia, Idaho, Iowa, Maine, Michigan, Missouri, Montana, Nebraska, North Carolina, North Dakota, Ohio, Oregon, South Carolina, South Dakota, Tennessee, Vermont, West Virginia, and Wisconsin. *Id.* at 10 n.28.

[36] MOFSKY 11-12.

[37] Hall v. Geiger-Jones Co., 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Merrick v. N.W. Halsey & Co., 242 U.S. 568 (1917).

was the year of the Liberty Loan to finance World War I which marked the beginning of the first truly national public securities markets. Thus, the cases deciding the constitutionality of the blue sky laws, like the statutes themselves, arose in the previous era when national securities markets were relatively undeveloped and nationwide securities distributions were infrequent.

During the next decade the spread of state securities registration statutes continued, usually following the merit standard or licensing approach introduced by Kansas with varying degrees of strictness.[38] Also, earlier statutes underwent revision, both to improve their draftsmanship and particularly to enlarge on the scope of the exemptions. Indeed, it was soon recognized by those who opposed the blue sky laws on the grounds that they were unreasonably severe that political realities in state legislatures made it far easier to expand the area of exemptions than to effect repeal of the laws or to alter the basic philosophy of regulation.[39] Thus, this pattern, which has continued ever since,[40] meant that, despite the apparent strictness of the blue sky laws and their wider adoption, their actual impact was narrowing in scope and a growing volume of securities transactions was unaffected by them. This phenomenon helps to explain why, despite the proliferation of blue sky laws, American securities markets underwent dramatic expansion during the decade following World War I and culminated in the devastating market crash of 1929, against which the blue sky laws had provided American investors virtually no protection whatever.

Federal securities registration requirements began with the Securities Act of 1933.[41] By that time three facts existed which materially affected the approach adopted in the federal act in two basic respects. First, securities registration at the state level was widespread and well established. Second, beginning with the market collapse in 1929 public securities markets had experienced a severe loss of public confidence in investment in corporate securities. Third, public securities markets and public investment in corporate investment had grown substantially, both numerically and geographically, by that time, and public sophistication with respect to investment in corporate securities was significantly greater than it had been when the blue sky laws were first adopted.

With these facts in evidence two decisions of basic importance were made in the Securities Act of 1933. First, the securities registration requirements of the Act were formulated entirely on the basis of the disclosure philosophy of the British statutes, which had experienced decades of success in Britain.[42] An issuer offering securities for sale to the public was required to make full disclosure to each prospective investor of all information necessary for him to make an informed investment decision; and this requirement was coupled with efficient statutory civil remedies for any deficiency in the disclosure. But no administrative authority was given jurisdiction

[38] 1 Loss 28; Mofsky 12.
[39] 1 Loss 64-67; Mofsky 12.
[40] *See* Mofsky 59-66.
[41] 15 U.S.C. §§ 77a-aa (1970).
[42] 1 Loss 121-28; Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29 (1959).

to control or condition access to the public financial markets on the basis of a determination of the investment merits of the security. Second, the decision was made to include in the statute an express non-preemption provision to preserve all existing state regulation in addition to the new federal regulation.[43]

The decision to adopt the disclosure philosophy in the Securities Act of 1933, rather than the prevailing state merit standard philosophy, is significant. The first bills introduced in Congress to impose federal securities registration requirements were patterned after existing state statutes and incorporated the state merit standard philosophy.[44] Ultimately, however, this approach was specifically rejected and the bill based on the English disclosure philosophy was adopted instead.[45] This decision was based on the belief that a federal qualification statute based on merit standards would be unworkable and unreasonable, and that, in any event, this was not the best approach to securities registration. Congress considered it necessary to protect both the public investor and the financial needs of business enterprises. With this purpose in view the disclosure philosophy was chosen as the best protection for public investors, since it allowed each investor to make his own investment decision based on full information, without imposing an unreasonable restraint on legitimate business finance. Finally, it was considered essential to avoid the risk of implicit approval by the federal government of the merits of any securities offered for sale to the public, since all securities involve some degree of investment risk.[46]

C. *The Regulatory Dilemma and Attempts To Resolve It*

Due to the two basic decisions in the adoption of the Securities Act of 1933 described above, corporate issuers making public distributions of securities to raise needed capital have, since 1933, been confronted with the regulatory dilemma outlined at the beginning of this Article. This involves both a multiplicity of regulatory jurisdictions and a fundamental contrast of regulatory philosophies.

The difficulties inherent in this situation began to receive attention in the years following World War II and produced substantial debate over the best solution. Ultimately a special study of blue sky law by Professor Loss and Edward M. Cowett resulted in the drafting and promulgation of the Uniform Securities Act in 1956,[47] the declared purposes and policies of which were to achieve maximum uniformity among the states and coordination between state and federal securities registration requirements.[48] But in

---

43 Securities Act of 1933, § 18, 15 U.S.C. § 77r (1970). In view of the recent collapse of the securities markets and loss of investor confidence, there was, as a practical matter, little prospect of displacing the entrenched blue sky laws with a new federal act. Furthermore, such an attempt might well have increased constitutional uncertainties concerning the Securities Act under the judicial attitudes which then prevailed.

44 Landis, *supra* note 42, at 30-33.

45 *Id.* at 32-49. *See also* 1 Loss 121-28.

46 Landis, *supra* note 42, at 32-49. *See also* 1 Loss 121-28.

47 Loss & Cowett 233-34.

48 Uniform Securities Act § 415.

order to achieve maximum acceptance of the Act it was considered to be a political necessity to adhere essentially to the prevailing merit standard philosophy in a modified form.[49]

In the years following 1956 the Uniform Act was widely acclaimed as a major achievement and a substantial improvement in state securities regulation. It has been adopted in whole or in part by a great many states. However, in many of these states significant changes have been made, often at the points at which uniformity was considered most necessary.[50] As a result, comment on the success of the Uniform Act has varied. Some have criticized it for not shifting to the disclosure philosophy of securities registration.[51] Others have criticized it as aiming at a mediocre leveling of otherwise effective state securities legislation.[52] Still others have concluded that the Uniform Act has actually achieved more in the area of providing model statutory provisions in specific areas than in producing uniformity among the states in those areas where uniformity was the most necessary.[53] In any event, the Uniform Act, though a monumental piece of legislative draftsmanship, has not actually resulted in a solution to the problems.

To some extent, difficulties in this area have been reduced by the efforts of North American Securities Administrators and similar regional groups in achieving a significant amount of cooperation among various administrators and some uniformity of approach to common problems.[54] Of particular importance also is the development of uniform registration forms which may be used in many states.[55] This materially reduces the volume of paper work and some of the practical problems.[56] Nevertheless, the fact remains that each of the administrators operating under a merit standard must make his own individual decision concerning the merits of the proposed securities offering, and there is substantial risk that their decisions and the conditions they may impose may differ significantly. Thus, actual uniformity appears to be elusive, the regulatory dilemma remains, and the debate as to how it should be resolved has continued to the present.

II. AN ANALYSIS OF THE DEBATE OVER THE SOLUTION TO THE PROBLEM

A. *The Patterns of Debate*

The continuing debate over the best solution to the problems created by the multiplicity and the disparity of securities registration requirements un-

---

49 Loss & COWETT 236-38.

50 Hill, *Some Comments on the Uniform Securities Act*, 55 NW. U.L. REV. 661 (1961); Loss, *Developments in Blue Sky Laws*, 14 BUS. LAW. 1161 (1959).

51 Bromberg, Book Review, 12 J. LEGAL ED. 127, 133-36 (1959).

52 Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193, 222-30 (1958). *But see* Brainin & Davis, *State Regulation of the Sale of Securities: Some Comments*, 14 BUS. LAW. 456 (1959), who criticize the Act for tending to "level up" or increase the overall state regulation of the sale of securities.

53 Hill, *supra* note 50.

54 1 BLUE SKY L. REP. ¶ 507 (1967); 1 Loss 90-91.

55 1 BLUE SKY L. REP. ¶¶ 4471-73 (1963); 4 Loss 2260-62 (Supp. 1969).

56 *Cf.* Brainin & Davis, *supra* note 52, who view this as the principal practicable objective of blue sky law reform.

der federal and state law has as yet failed to produce any generally accepted solution. The positions taken in the course of this debate tend to fall into three broad categories. First, some have argued vigorously for full federal preemption of the field and the elimination of all state jurisdiction with respect to registration of securities offered for sale to the public, whether on the basis of the merit standard philosophy, the disclosure philosophy, or any other principle.[57] Second, this argument has been countered with an equally vigorous defense of state jurisdiction and the right of each state to require registration of securities offered for sale to the public on any basis the state deems appropriate to protect its citizens.[58] Usually, however, the defenders of state jurisdiction are, at the same time, the principal advocates of the merit standard philosophy and critics of the disclosure philosophy.[59] Finally, the Uniform Securities Act has been urged by the third group as the best solution and a reasonable compromise, since it retains both state jurisdiction and the merit standard approach, but in a modified form, and would promote uniformity among the states and coordination with federal requirements. This, it is argued, should substantially reduce the problems in this area.[60]

As might be expected, the principal criticism of each of the three main positions tends to come from the advocates of the other two. Thus far the result has been that state jurisdiction and the merit standard system have been retained, which is consistent with two of the positions advanced. But the state requirements have been modified both by the influence of the Uniform Act and by a growing emphasis on the part of the states on disclosure to investors, usually in addition to merit standards.[61] The Uni-

---

[57] Armstrong, *The Blue Sky Laws*, 44 VA. L. REV. 713 (1958); Millonzi, *Concurrent Regulation of Interstate Securities Issues: The Need for Congressional Reappraisal*, 49 VA. L. REV. 1483 (1963); Rostow, Book Review, 62 YALE L.J. 675, 677 (1953). *But cf.* Bennett, *Federal Regulation of Securities: An Appraisal of Policy*, 7 J. PUB. L. 410 (1958), who opposes federal preemption if it entails shifting the federal regulatory philosophy to any form of merit standard regulation. *See also* Gray, *Blue Sky Practice—A Morass?*, 15 WAYNE L. REV. 1519 (1969).

[58] Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417 (1969); Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193 (1958).

[59] *See* Hueni, *supra* note 58; Jennings, *supra* note 58; *cf.* MOFSKY; Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447 (1969); Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273; Mofsky, *Reform of the Blue Sky Laws*, 23 VAND. L. REV. 599 (1970); Mofsky, *State Securities Regulation and New Promotions: A Case History*, 15 WAYNE L. REV. 1401 (1969), all of which advance vigorous criticisms of state merit standard regulations and argue for reform at the state level.

[60] 1 Loss 102-05; Loss & COWETT 236-44; Loss, *The Uniform Securities Act and the Bar*, 13 BUS. LAW. 609 (1958). *See also* Edwards, *California Measures the Uniform Securities Act Against Its Corporate Securities Law*, 15 BUS. LAW. 814 (1960); Hill, *supra* note 50. Brainin & Davis, *supra* note 52, however, are generally critical of both the Uniform Act and the federal preemption argument as failing to offer any practical solution to the lawyer's problems in coping with the admittedly troublesome system of state blue sky regulation.

[61] Most states with traditional merit standard systems of securities registration have added in recent years requirements of disclosure to investors, through use of a prospectus or other means. In addition, a few states in very recent years have adopted securities registration statutes based primarily on the disclosure philosophy. The latter group includes Colorado, Maryland, Nebraska, New York, and Virginia, each of which has embraced the disclosure philosophy in its own distinct way. *See* 1 Loss 54-58; 4 *id.*

form Act has been adopted by a significant number of states, but frequently with important changes at critical points. Many leading states, however, have not adopted it.[62] Hence, there has been some change in the overall situation, but the issues have not been resolved, nor have the problems been eliminated. It is, therefore, appropriate to examine closely each of the three arguments which have been advanced in the debate and the criticism of it by its opponents.

Federal Preemption. The argument for full federal preemption of state jurisdiction[63] is based essentially on three interrelated premises. First, it is argued that modern American securities markets have developed into a fully unified national financial community which should only be regulated on the national level and not subjected to multiple, diverse local regulation, since this will materially and unreasonably interfere with nationwide financing of legitimate business enterprise. In this respect it is pointed out that business needs and the financial markets have developed dramatically since the blue sky laws originated in 1911 and since the blue sky cases were decided in 1917. Therefore, it is observed, there has necessarily been a commensurate growth in the numbers, experience, and sophistication of the investing public during that time, and the development of an intricate and efficient nationwide securities marketing industry.

This conclusion leads into the second premise of the preemption argument. It is argued that the modern investing public and the needs of highly developed free securities markets are today better served and better protected by regulation based on the disclosure philosophy, which gives investors a free choice of investment risks with an adequate, reliable supply of information on the basis of which to make intelligent investment decisions. It is contended that state blue sky laws based on the merit standard principle are anachronistic and constitute an unreasonable restraint on free investment decisions by members of the public and on free securities markets under contemporary conditions.

Finally, the preemption argument emphasizes the high degree of skill, sophistication, and flexibility which has traditionally characterized the administration of the federal securities laws by the SEC, in contrast to the often inept, understaffed, and occasionally biased, manner in which many state securities agencies have functioned under blue sky statutes. It is also argued that the equally superior federal disclosure philosophy reflects a national policy as to the best and most reasonable method of regulation in modern nationwide securities markets, and that the disclosure philosophy should, therefore, be made exclusive by preemption of the parallel state regulation based on the merit standard philosophy.

Critics of the preemption argument[64] have leveled three basic objections to

---

2227-30 (Supp. 1969); Loss, *Developments in Blue Sky Laws,* 15 BUS. LAW. 1021 (1960); Loss, *supra* note 50, at 1164-65.

[62] Among the leading states, in terms of size and commercial activity, which have substantial securities registration requirements and which have not adopted the Uniform Act are California, Florida, Illinois, Minnesota, Ohio, and Texas.

[63] *See* note 57 *supra.*

[64] *See* note 58 *supra.*

it, which thus far have prevented its gaining general acceptance. First, it is argued that it is both politically not feasible and socially undesirable to preempt state laws designed to protect local residents from securities fraud and overreaching. To persuade Congress to take such a step would be extremely difficult, if not impossible. In addition, it is argued that each state should have the right to protect its citizens in the area of corporate abuses, and that the states should be free to experiment with various methods to achieve this end under the principles of federalism.

Second, it is observed that the SEC, despite its outstanding performance in administering the federal laws, is wholly unequipped to take on the vast additional burden implied in federal preemption. Even with its present work load the SEC is frequently understaffed and unable to handle its work load on a current basis. On occasions its work load has actually been increased due to changing conditions in the securities markets just at a time when political and budget considerations were forcing limitations on appropriations for additional staff.

Finally, it is contended that the disclosure system provided by the Securities Act of 1933 is too mild a method of regulation to provide adequate protection to the investing public. This criticism usually relies essentially on two points, which reveal its limited scope. First, it is clear that specific problems have arisen under the system of disclosure provided by the Securities Act of 1933. These include such matters as the unreadability of many prospectuses and the fact that effective dissemination of prospectuses to investors has not been adequately guaranteed prior to the actual making of investment decisions. Second, the critics of the disclosure philosophy focus on a few spectacular historic instances of bad investment decisions by many members of the public despite the full disclosure provided them under the Securities Act of 1933. These instances are pointed to as demonstrating that the investing public fails to make adequate use of the required disclosure to protect itself against unsound investments. From this premise it is argued that the disclosure philosophy itself is incapable of providing adequate protection to the public.

Retention of State Securities Registration. The argument in favor of maintaining the present pattern of state securities registration based on the merit standard philosophy[65] is thus predicated chiefly on the three criticisms leveled at the federal preemption argument. First, it is contended that it is only consistent with the principles of federalism to allow the states this degree of freedom to experiment with improvements in their corporate laws in an effort to protect their citizens from securities fraud and overreaching by unscrupulous promoters. Second, it is argued that the SEC is overworked and understaffed with its present responsibilities and is entirely unequipped to undertake the exclusive regulatory role in modern financial markets. Third, the disclosure philosophy is rejected as totally inadequate to protect the public from the devious schemes of the fraudulent. It is ar-

---

[65] *Id.*

gued that securities registration on the merit philosophy is alone adequate to achieve this goal.

This argument for maintaining the status quo is rebutted on the basis of three principal contentions,[66] which correspond in part to the arguments in favor of federal preemption. First, it is argued that the existing state registration requirements impose an unreasonable burden on an essentially interstate economy and unduly restrict legitimate business financing and free investment markets. Second, it is argued that the diversity of administrative regulation and interpretation under discretionary merit standards creates a pointless degree of confusion, complexity, paperwork, and uncertainty, which far exceeds reasonable state experimentation under the principles of federalism. Finally, it is argued that the merit standard philosophy is actually inadequate to protect the public and that the disclosure philosophy is more effective. It is also argued that the state merit standard philosophy often imposes unfair and discriminatory requirements on a new business, which fails to provide much actual protection to the public but which tends to reflect the prejudices and fallible judgments of the administrator.[67] Thus, new industrial development and economic growth may be restrained, while the truly unscrupulous, who make no effort to comply with the registration requirements, may go unchecked because the state administrator will frequently lack adequate resources and staff for vigorous enforcement of the antifraud provisions of the statute, due, in part, to concentration of resources and staff on the administration of the securities registration provisions.

Adoption of the Uniform Securities Act. As the third principal alternative, the Uniform Act has been urged as a moderate, balanced position which would deny the extremes of both of the two foregoing positions.[68] The Uniform Act, it is argued, would allow retention of both state jurisdiction and a significantly modified merit standard system of securities registration, which would overcome the major political and practical obstacles to the federal preemption argument. The Uniform Act would, however, create both an important degree of uniformity between those states which adopt it and a unique system of coordination between the state and federal registration of an interstate securities offering.

Although the Uniform Act has been recognized as a major achievement and a substantial improvement over the previously existing condition, it is also clear that the Uniform Act has failed to eliminate the problems in this area for three reasons. First, several of the principal financial states have not adopted the Uniform Act in any form. Second, many of the states which have purported to adopt the Uniform Act have made basic changes in key provisions, with the result that there is much less actual uniformity

[66] *See* notes 57-59 *supra.*
[67] *See* MOFSKY; Bloomenthal, *supra* note 59; Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273; Mofsky, *Reform of the Blue Sky Laws*, 23 VAND. L. REV. 599 (1970); Mofsky, *State Securities Regulation and New Promotions: A Case History*, 15 WAYNE L. REV. 1401 (1969).
[68] *See* note 60 *supra.*

among even those states than might reasonably have been expected.

Finally, the retention of the merit standard philosophy in the Uniform Act creates an inevitable risk of uncertainty and lack of uniformity with respect to the actual administrative interpretation of the merit standards as applied to each securities offering. Even if all states with securities registration statutes should limit the administrator's discretion to deny registration to those issues which have "worked or tended to work a fraud upon a purchaser or would so operate" and those which involve "unreasonable" promoters' compensation and underwriting costs, the sweeping discretion conferred by these provisions is highly subjective with each state's administrator and is thus inherently unpredictable. Each administrator must use his own interpretive judgment with respect to each securities offering to determine what, in his opinion, "tends to work a fraud" and what costs are "unreasonable." It is not likely that numerous state administrators operating independently under registration standards of this type will draw the same inferences and reach the same conclusions on any given securities offering. Nor is there much assurance that two or more issues with similar attributes will receive consistently similar rulings in the same state, although this problem may be reduced by published administrative rules and experienced personnel. Indeed, there is little likelihood of actual uniformity among the states so long as discretionary merit standards are retained as the basis of securities registration at the state level.

B. *An Analysis of the Issues Raised in the Debate*

From the foregoing it can be seen that throughout the debate regarding the problems created by state securities registration requirements there have actually been two fundamental and essentially distinct issues on which opinion has divided: First, whether state jurisdiction with respect to securities registration is reasonable and valuable or whether it should be totally preempted by federal jurisdiction; and second, whether the better approach to securities registration requirements is represented in the merit standard philosophy, which has been traditional in state law, or is reflected in the disclosure philosophy.

Each of the three major positions in the debate has presented a combined position on these two issues, but little attention has been devoted to separating the two issues and considering the merits of each independently. Nor have the three major positions in the debate included all of the possible combinations of positions on the two basic issues. Since the debate along these lines has thus far failed to produce a completely satisfactory solution, the two fundamental issues should be separated and considered independently on their merits, and new combinations of positions on them should be explored.

The federal preemption argument has presented a combined argument in favor of both exclusive federal regulation and the disclosure philosophy, and has opposed both state jurisdiction and the merit standard philosophy. In rebutting the preemption argument, the status quo advocates have defended state jurisdiction against the threat of federal preemption and have criticized the disclosure philosophy, particularly as represented in the Securities Act of 1933, in defense of the merit standard philosophy. The Uniform Securities Act, though representing a moderate view, has sided with the status quo argument on the two fundamental issues, since it proposes retention of both state jurisdiction and a modified form of the merit standard philosophy.

No serious consideration has been given to the remaining combination of positions on the two basic issues. This view would propose retention of state jurisdiction with respect to securities registration, provided that the state registration requirements were based on some form of the disclosure philosophy rather than on the merit standard philosophy. State requirements would then be consistent with the federal securities registration policy based on the disclosure principle and would avoid unreasonable interference with national financial and securities markets. It is submitted that this possibility should be examined more carefully.

If the question of state jurisdiction with respect to securities registration is considered separately from the dispute between the disclosure philosophy and the merit standard philosophy, it becomes clear that there need be no serious objection to state jurisdiction per se, provided state regulation does not invoke a philosophy which conflicts with the policy of the parallel federal regulation, or which imposes serious burdens on interstate financial markets and securities distributions. Indeed, if the state regulation were based on a policy entirely consistent with and complementary to the parallel federal regulation, the additional manpower and ideas of the state regulatory agencies could be an extremely helpful supplement to the SEC in the common effort to protect public investors through disclosure, without unreasonably hindering legitimate business financing and avenues of public investment. If the basic policy conflict were eliminated, reasonable experimentation at the state level with new and improved methods of implementing the disclosure philosophy would be entirely consistent with the principles of federalism, and might produce better techniques for effective disclosure to investors than have been developed thus far under the federal statute.

On the other hand, the key problems which confront the federal preemption argument are the practical and political difficulties raised by proposing to eliminate the role of the existing state regulatory agencies and to vest exclusive authority in the SEC. There is inevitable resistance to any proposal which would both eliminate the employment of numerous state officials and also deny the states any active role in protecting the public with respect to securities distributions within their borders. In addition, the SEC is not adequately staffed to undertake the exclusive responsibility in this area, nor is it likely to be. Indeed, the SEC has indicated that it appreciates the assistance and cooperation it now receives from the state securities agencies.[69] Therefore, if state jurisdiction with respect to securities registration could be retained, but state registration requirements could be

---

69 *See* MOFSKY 85.

restricted to a policy consistent with the parallel federal regulation, most of the practical difficulties encountered by the federal preemption argument would be overcome, and many of the hardships on legitimate interstate securities markets would be relieved.

C. *An Analysis of the Merit Standard Philosophy of Securities Registration*

From the foregoing analysis it is clear that the critical issue in the debate is not actually the issue of state jurisdiction or federal preemption. Rather, it is the conflict between the federal disclosure philosophy of securities registration and the state merit standard philosophy. Indeed, many of the most aggravated problems created by state securities registration are directly attributable to the merit standard approach itself, and it is arguable that this alone is the ultimate source of the regulatory dilemma. Yet the traditional state merit standard philosophy is vigorously defended by the opponents of federal preemption as being essential to provide adequate protection for the public.[70] It is necessary, therefore, to consider the merits of this argument and the validity of the state merit standard theory in contemporary financial and securities markets.

The historical origin of the state merit standard philosophy of securities registration in Populist economic theory reflects a desire to protect a predominantly agrarian populace in the western and southern states which had limited experience in business and financial matters, against oppression by the business and financial world of the "Moneyed East" in the era before World War I, when federal securities regulation was nonexistent.[71] In this historical context a licensing requirement for all securities offered for sale, with broad discretion in a public administrator to pass on the merits of the security, was not unreasonable. However, the validity of this regulatory concept in practice in the modern world is questionable for several reasons.

First, the success of the merit standard system standing alone depends entirely on the adequacy of the administrator's review of each proposed securities offering and on the reliability of his judgment of the merits. This process has several limitations. It is quite possible that the most unscrupulous promoters, who have little hope of meeting the merit standards, will frequently ignore the registration requirement altogether and take their chances.[72] Since many administrators have their staffs fully occupied with administration of detailed merit standards, there will often be little likelihood of detection and restraint of illegal offerings and, thus, no public protection at all where it is most needed. As to distributions which are registered, the administrator's judgment on the merits is entirely human and, therefore, both fallible and subject to personal bias. Indeed, it is a perennial fact that the administrator is potentially corruptible and may actually become dangerous to public investors, since his approval of the merits of a se-

[70] *See* note 58 *supra.*
[71] *See* part I, section B, *supra.*
[72] This has been suggested by Professor Bloomenthal. Bloomenthal, *supra* note 59.

curity may carry great weight with them.[73] In any event, it is only necessary for the fraudulent or overreaching applicant for registration to deceive the single administrator under the merit standard system, whereas under the disclosure philosophy it becomes necessary for him to deceive all potential investors, which is certain to be far more difficult.

However, a much more basic difficulty inherent in the merit standard system lies in the fact that the administrator is presented with an extremely difficult, if not impossible, task. Conceptually, he is expected to act in a capacity equivalent to that of an investment adviser to the public as to registered issues. It is his responsibility to assess the complex patterns of risks and rewards involved in an unlimited variety of securities offerings, all of which present some combination of potential risk and potential reward. Public investors themselves usually disagree widely on the desirability of each securities offering, since they are motivated by a variety of different investment purposes and ambitions. Nevertheless, the administrator under the merit standard system may, in his discretionary judgment, impose the sanction of illegality on some offerings, while granting to others the privilege of legality. In principle, this is intended to protect public investors against the risk of loss inherent in unsound investments, but it is clearly beyond the powers of the administrator to provide such protection. Those securities which he approves and permits to be sold to the public always involve some degree of risk, which may ultimately lead to serious loss for those who invest in them. On the other hand, those securities which the administrator concludes are too risky to be sold to the public and which are denied registration, may in fact prove ultimately to be highly successful investments in spite of their original speculative risks. When this happens, the public has suffered a double loss: It has been denied an opportunity to participate in a rewarding investment, and it has also lost the economic benefit of a successful publicly financed business. In short, the administrator can easily be in error whatever his decision, and whenever he errs in either direction, the public will suffer the loss.

An additional limitation on the degree of public protection actually afforded by the merit standard theory is the fact that most of the state statutes also contain extensive exemptions, the effect of which is to allow public marketing of many new securities offerings and to permit virtually all activity in the securities trading markets to be conducted free of any form of securities registration.[74] Since the securities trading markets actually represent the major source of public securities investments,[75] it is obvious that public investors may incur substantial losses in those investments with no protection whatever from the apparently strict merit standards which are only

[73] Most state securities administrators, present and past, have been conscientious men of high integrity. Unfortunately, however, there have been a few notable exceptions. The only point intended to be made here is that the possibility of corruption is inescapable in any public office and that the merit standard philosophy inherently augments the risk of harm from this possibility due to the subjective, discretionary power it vests in the administrator.

[74] The scope of the exemptions of principal importance in contemporary state blue sky laws is summarized and tabulated in MOFSKY.

[75] *See* part I, section A, *supra*. *See also* WHEAT REPORT 57-62, and app. II-1.

applied to a limited number of new issues.

In addition, the broad exemptions applicable to public securities distributions by a large number of established issuers produce the result that the strict merit standards actually apply primarily to newer businesses which may be in the early stage of development and which have relatively few shareholders. As Professor Mofsky has demonstrated,[76] this results in a clear tendency to discriminate against new enterprises in favor of older, established businesses and, thus, to restrain potential competition. This is indeed a surprising result for the system initiated by Populism. Nevertheless, this curious pattern of discrimination against the public financing of new business enterprise may actually have inhibited business and industrial growth in the agrarian areas where Populism flourished.[77]

The ultimate objection to the merit standard philosophy lies in the awesome power of the administrator, who is vested with sweeping discretionary judgment to pass on each new securities offering subject to registration with the potential sanction of illegality for those disapproved. This virtually unchallengeable power to grant, deny, or condition access to the public capital markets as the administrator may deem appropriate plays an extremely questionable role in otherwise free financial and securities markets. The administrator is, in effect, given the power to control and direct the flow of public investment capital among businesses and industries in accordance with his judgment of their respective public desirability. Through the same discretionary power, he is given the ability to control those new investment opportunities which may become available to the public. Stripped to its essentials, the merit standard philosophy creates in the administrator an economic and financial potentate, whose tremendous power is too seriously subject to potential abuse. The legitimacy of this power in a free society raises the most serious questions, which have only been avoided in the modern era by the creation of extensive statutory exemptions. Commensurate with the discretionary power vested in the administrator is the fact that, as to those issues which are allowed to be sold to the public, it is impossible to avoid the implication of official approval of the merits of the securities. The likelihood of public reliance on this implication is obvious, despite the disclaimers usually required. Indeed, under the merit standard system it is the duty of the administrator to pass on the merits of registered securities offered to the public. Unless the administrator has failed to discharge this responsibility, the usual disclaimers of official approval of the securities offered clearly contradict the facts and are meaningless.

In the last analysis, the merit standard system seriously overrates and overrelies on the wisdom and judgment of a single public official and creates inherently dangerous obstacles to free access to public capital markets and to a free choice of public investment opportunities. The result, in practical experience, is that the public investor receives far less actual protection from

[76] *See* MOFSKY; Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273; Mofsky, *Reform of the Blue Sky Laws*, 23 VAND. L. REV. 599 (1970); Mofsky, *State Securities Regulation and New Promotions: A Case History*, 15 WAYNE L. REV. 1401 (1969).

[77] *See* Authority cited note 67 *supra*.

the merit standard system than it pretends to afford. It is equally clear that so long as the merit standard system is retained by the states, uniformity is highly unlikely, since it is reasonable to assume that state administrators applying discretionary, subjective criteria to each registered securities distribution will not all think alike all of the time.

III. A Proposal for a New Approach to a Solution to the Problem

A. *An Analysis of the Disclosure Philosophy of Securities Registration Under Contemporary Conditions*

The foregoing considerations lead to the necessity for a careful evaluation at this point of the disclosure philosophy of securities registration as it contrasts with the merit standard philosophy and as it relates to the needs of public investors under contemporary conditions. It is submitted that the disclosure philosophy is, in principle, far more promising than the merit standard philosophy as a means of providing adequate protection for public investors in contemporary securities markets. In view of the great variety of securities available to contemporary investors and the many combinations of risk and reward which they represent, the classic arguments of Louis Brandeis in support of full disclosure as the best means of public investor protection are equally as forceful and relevant to the needs of investors today as they were in 1914:

> Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman. And publicity has already played an important part in the struggle against the Money Trust [through the investigation by the Pujo Committee concerning financial concentration] . . . . But there should be a further call upon publicity for service. That potent force must, in the impending struggle, be utilized in many ways as a continuous remedial measure.[78]

After discussing the investigation and recommendations of the Pujo Committee concerning excessive underwriting charges and the Committee's proposals that regulatory authority be vested in the Interstate Commerce Commission with respect to certain railroad securities issues, Brandeis continued:

> Publicity offers, however, another and even more promising remedy: a method of regulating bankers' charges which would apply automatically to railroad, public-service and industrial corporations alike.
>
> The question may be asked: Why have these excessive charges been submitted to? . . . [W]hy have the investors submitted, since ultimately all these charges are borne by the investors, except so far as corporations succeed in shifting the burden upon the community? . . . But the investor's servility is due partly, also, to his ignorance of the facts. Is it not probable that, if each investor knew the extent to which the security he buys from the banker is diluted by excessive under-

[78] L. Brandeis, *supra* note 11, at 92. The Pujo Committee was formed by the House Banking and Currency Committee to investigate the "Money Trust" and its effect on the New York Stock Exchange. For the report of the Pujo Committee, see H.R. Rep. No. 1593, 62d Cong., 3d Sess. (1913).

> writings, commissions and profits, there would be a strike of capital against these unjust exactions?
>
> A recent British experience supports this view. . . .
>
> Compel bankers when issuing securities to make public the commissions or profits they are receiving. Let every circular letter, prospectus or advertisement of a bond or stock show clearly what the banker received for his middleman-services, and what the bonds and stocks net the issuing corporation. That is knowledge to which both the existing security holder and the prospective purchaser is fairly entitled. If the bankers' compensation is reasonable, considering the skill and risk involved, there can be no objection to making it known. If it is not reasonable, the investor will 'strike,' as investors seem to have done recently in England.
>
> Such disclosures of bankers' commissions or profits is demanded also for another reason: It will aid the investor in judging of the safety of the investment. . . . *Now the law should not undertake* (except incidentally in connection with railroads and public-service corporations) *to fix bankers' profits. And it should not seek to prevent investors from making bad bargains. But it is now recognized in the simplest merchandising, that there should be full disclosures.* The archaic doctrine of *caveat emptor* is vanishing. The law has begun to require publicity in aid of fair dealing. . . . Require a full disclosure to the investor of the amount of commissions and profits paid; and not only will investors be put on their guard, but bankers' compensation will tend to adjust itself automatically to what is fair and reasonable. Excessive commissions—this form of unjustly acquired wealth—will in large part cease.
>
> But the disclosure must be real. And it must be disclosure to the investor. It will not suffice to require merely the filing of a statement of facts with the Commissioner of Corporations or with a score of other officials, federal and state. . . .
>
> To be effective, knowledge of the facts must be actually brought home to the investor, and this can best be done by requiring the facts to be stated in good, large type in every notice, circular, letter and advertisement inviting the investor to purchase. Compliance with this requirement should also be obligatory, and not something which the investor could waive. For the whole public is interested in putting an end to the bankers' exactions. . . .
>
> The required publicity should also include a disclosure of all participants in an underwriting. . . . The investor should know whether his adviser is disinterested.[79]

Admittedly Brandeis' remarks were not directly addressed to the present issue of federal-state relations in the area of securities registration or to the implicit tension between the merit standard philosophy and the disclosure philosophy. Nevertheless, his arguments in support of the disclosure philosophy are extremely relevant to the present subject for several reasons. First, Brandeis' major concern was to expose and prevent the gross abuses of "the Money Trust" in handling public securities distributions to the detriment of both public investors and publicly held corporations which he described in detail. He advocated the disclosure philosophy, therefore, not

[79] *Id.* at 98-105 (emphasis added).

to lighten the regulatory burden on those who would abuse the public trust in securities distributions, but because he was convinced that it was the most effective method of actually preventing the abuses which he deplored. Second, it is clear that he regarded the disclosure principle as a superior method of protecting the public in securities distributions in contrast to the essentially regulatory proposals of the Pujo Committee. While Brandeis was not immediately concerned with state blue sky law, the Kansas act of 1911 had been enacted two years earlier and was already being copied elsewhere when he wrote. The merit standard philosophy reflected in the Kansas act was similar in nature to the regulatory proposals of the Pujo Committee, which Brandeis regarded as less adequate to protect public investors than the full disclosure philosophy which he espoused. Also, he expressly rejected the underlying premise of general merit standard regulation. Finally, it is very clear that Brandeis' arguments in support of the disclosure philosophy as the best method of protection for public investors were a major influence in the decision to adopt the disclosure principle in the Securities Act of 1933 in preference to the merit standard philosophy as reflected in the state blue sky laws then in existence.[80] Thus, Brandeis' analysis of the superiority of the disclosure philosophy is implicitly reflected in federal securities registration policy to the present.

In addition to Brandeis' arguments, it is clear that the disclosure philosophy is far more compatible with a free society and with free financial markets than the merit standard philosophy. No public official is given the impossible task of passing on the merits of each securities distribution on behalf of all members of the public under the disclosure philosophy. Instead, each prospective investor is free to make his own investment decision on the basis of his own assessment of the potential risks and the potential rewards involved in each distribution, and in order to do so he is supplied with complete and reliable investment information. If he chooses to do so, he may take large risks in the hope of large returns on speculative investments. He is not denied this liberty by a public official who may have a more conservative investment philosophy and who will not permit high risk or speculative securities offerings to be made to the public under his interpretation of the traditional merit standards.

The disclosure philosophy also guarantees that all business enterprises will have access to the public capital markets, provided the truth is told. No public official or agency is empowered to control the flow of capital investment among businesses. That this is more consistent with a free society and a free economy than the merit standard system is obvious. Its importance can scarcely be overstated. The history of the growth of American business and industry and of the public securities markets since the turn of the century demonstrates that free access to public capital markets is essential to the vitality and continued expansion of business and industry. The merit standard philosophy inevitably injects governmental control over access to capital on the thesis of investor protection. The disclosure philos-

[80] *See* note 42 *supra*, and accompanying text.

ophy, on the other hand, offers superior protection to public investors, without governmental interference with access to the public capital markets.

The stature and effectiveness of the disclosure philosophy is perhaps best demonstrated by its general success in British securities law and under the Securities Act of 1933. Although entering American securities law more than two decades after the beginning of the state merit standard system of securities registration, the SEC interpretation and enforcement of the disclosure philosophy under the Securities Act of 1933 has become widely regarded today as the principal source of investor protection in new securities distributions. Indeed, specific problems with the particular disclosure system provided by the Securities Act of 1933 and past SEC interpretation have been recognized and have been emphasized by critics of the disclosure philosophy as proof of its inadequacy. Nevertheless, the analysis in the *Wheat Report* and subsequent SEC actions based on its recommendations make it clear that the disclosure philosophy itself is valid and should be continued. Specific problems which have arisen are viewed as shortcomings of the particular implementation of the disclosure philosophy under the Securities Act of 1933, which could be remedied by new interpretive and rule-making actions by the SEC and, in part, by statutory revision.

Critics of the disclosure philosophy usually contend that merit standard regulation is necessary to protect public investors from loss on highly speculative ventures, which investors may buy, and in certain famous instances have bought, notwithstanding the disclosures required by the Securities Act of 1933. However, these instances do not support a conclusion that the state merit standard system is any better protection of the public against such losses. Indeed, the state merit standard system was in full effect during the same episodes but failed to prevent the losses incurred by the public. Also, the great market collapse and massive public losses on investments of the 1929-1933 period occurred notwithstanding two decades of public protection under the widespread state merit standard system of securities registration. It is clear, therefore, that neither system provides absolute assurance that public investors will not experience losses by investing in securities. The real issue is which of the two systems provides the greater protection for the investing public, the greater deterrence of fraud, and is in greater agreement with the principles of free financial and securities markets and a free society. It is submitted that the answer is the disclosure philosophy.

Furthermore, as demonstrated above, there have been major changes in the character of American securities markets and in the composition, experience, and sophistication of the investing public since the inauguration of the state merit standard system in 1911. Much of the thinking reflected in the origins of the state merit standard system presumed an agrarian population with little experience or sophistication in securities investments. While this may have been true in the Midwest in 1911, it is no longer true of the nation as a whole. Also, when the blue sky cases were decided in 1917, American securities markets were much smaller and less developed than today and were concentrated principally in eastern population centers.

Hence, the Supreme Court holding that state securities registration or licensing systems did not impose an unreasonable burden on interstate securities markets was not necessarily inconsistent with the conditions existing at that time. Nor was there then any federal statute or national policy on securities registration based on a different principle of regulation.

But since the era of 1911-1917, when the present patterns in state securities registration were established, there have been major changes in American financial life which bring into serious question the current validity of the policies established in that period. In the decades since World War I there has been major growth throughout American financial and securities markets and growth in the size, knowledgeability, and experience of the American investing public. As a result, the financial and securities markets today are highly organized and are essentially interstate and nationwide in character, and the investing public is large, experienced, and informed. It is, therefore, no longer reasonable to assume that the contemporary American investing public is wholly incapable of making its own investment decisions, if provided with adequate, timely, and accurate investment information. Nor is it true today that state securities registration based on the merit standard philosophy does not impose substantial burdens on interstate securities markets. Indeed, under present conditions virtually all public transactions in securities involve interstate securities markets, and local regulation of public securities transactions inescapably affects interstate commerce in securities. It is arguable that, today, state securities registration requirements predicated on the merit standard philosophy impose burdens on interstate securities markets which are both unreasonable and inconsistent with the policy of the parallel federal regulation based on the disclosure philosophy.

Based on the foregoing considerations, it is submitted that the disclosure philosophy is, under contemporary conditions, the most appropriate and effective principle of securities registration and is the philosophy which most adequately fulfills the real needs of contemporary American investors for protection in securities distributions. In addition, the disclosure philosophy is clearly the most consistent with free securities markets for investors and with free access by business and industry to the public capital markets. If those states which now impose securities registration requirements on public securities distributions predicated their requirements on the disclosure philosophy, rather than the merit standard philosophy, three important beneficial results would follow. First, the major problems created by the present system of state regulation based on the merit standard philosophy and concurrent federal regulation based on the disclosure philosophy would be eliminated. Although the disclosure requirements of the various regulatory authorities might differ with respect to a given securities distribution, it is unlikely that the different forms or methods of disclosure would conflict with each other or would impair or prevent access to the public capital markets in any state. The nature of the disclosure philosophy is such that different disclosure methods or requirements do not pose the risks of conflict or incompatibility that different regulatory requirements under the merit standard philosophy create. At the same time, the inherent conflict which now exists between the federal and state securities registration philosophies would be eliminated. Second, state administrators implementing the disclosure philosophy rather than the merit standard philosophy might well develop a variety of new and improved disclosure techniques which could make a significant contribution to the common effort to achieve maximum protection of public investors through the best and most effective application of the disclosure philosophy.

Finally, if the disclosure philosophy became nationwide and exclusive, the unreasonable restraints and burdens now imposed on interstate securities markets by the state merit standard philosophy would be removed, and the excessive power now lodged in state securities administrators under the merit standard system to control and condition access by business and industry to the public capital markets and to control and limit the new securities available to investors would be eliminated.[81] In short, the solution to the regulatory dilemma created by the prevailing system of state securities registration lies neither in the direction of uniformity of state statutes predicated on the merit standard philosophy, nor in the direction of federal preemption of state jurisdiction over the subject. Rather, the solution to the problem lies in the nationwide adoption and implementation of the disclosure philosophy, to the exclusion of the merit standard philosophy, whenever registration requirements are imposed on public securities distributions.

B. *A Proposal for the Federal Securities Code*

If the solution to the problems created by the present system of state securities registration is the nationwide adoption of the disclosure philosophy, to the exclusion of the merit standard philosophy, by all jurisdictions which impose securities registration requirements, the obvious question is: How can this be accomplished? Ideally, the answer would be that the states should be urged to reform their blue sky laws to adopt the disclosure philosophy of securities registration and to abandon the merit standard philosophy. Perhaps this effort might be fostered and encouraged by the promulgation of a new model or uniform state securities act premised on the disclosure philosophy. Indeed, such an effort might meet with partial success. But the experience already recorded with respect to the present Uniform Securities Act gives little encouragement to such an effort. Realistically, there is no reason to expect that the many states which have refused even to modify the *language* of their statutory merit standards to follow that ex-

[81] That these powers of state securities administrators are excessive and do impair access by business and industry to the public capital markets is best demonstrated by the countless examples in the experience of attorneys representing issuers seeking registration under the state merit standard system and in the files of the state administrators. Many issuers fail to qualify; many more may qualify only under severe financial strictures imposed by the administrator, which may be unacceptable if the business is to obtain the capital it needs. A good illustration is quoted from *Fortune Magazine* in CARY 1481-82. *See also* examples discussed in note 67 *supra.*

pressed in the present Uniform Act would be any more willing to adopt a model or uniform act premised on the disclosure philosophy. It is obvious that the problem with reform of the state blue sky laws at the state level is that success is entirely dependent on the state legislatures, which all too frequently are preoccupied with other business and are instinctively reluctant to change established traditions, particularly when the change is not supported—or is actively opposed—by the state securities administrator, as so often is the case.[82]

Therefore, it is submitted that the problem should be dealt with by the Federal Securities Code, as suggested by Professor Loss in the remarks quoted at the outset of this Article. It is abundantly clear by now that American securities and financial markets are thoroughly interstate in character and, thus, properly the subject of federal regulation under uniform national policies. On the other hand, it is neither feasible nor necessary to exclude the states from participation in the regulatory effort on the basis of full federal preemption. The answer lies in the concept of partial or qualified federal preemption to the extent necessary to achieve a uniform national policy with respect to registration requirements imposed on public securities distributions and on access to the public capital markets. This could be accomplished through the Federal Securities Code.

It is proposed, therefore, that the Federal Securities Code adopt the position that the disclosure philosophy, in principle, represents the paramount national policy with respect to all registration requirements which may be imposed on public securities distributions affecting interstate securities and financial markets, and that the Federal Securities Code preempt state regulation only to the extent that it is based on the inconsistent merit standard philosophy, but not to the extent that it is based on the disclosure philosophy. Under this proposal there would be no federal preemption of state *jurisdiction* to require registration of public securities distributions. But the state merit standard philosophy would be preempted by the Federal Securities Code on the basis of the proposition that this form of state regulation is inconsistent with the paramount federal regulatory philosophy applicable to the same transactions and creates unreasonable burdens and restraints on interstate securities markets under contemporary conditions.

In order to allow the states the maximum degree of freedom to experiment within the reasonable bounds of federalism, this proposal would not restrict the state regulation to the specific methods of implementing the disclosure philosophy adopted by the federal regulation. On the contrary, the states should be free, and, indeed, should be encouraged, to explore new and different methods of achieving full disclosure of all material facts for the protection of public investors. Imaginative innovation by the states within the broad parameters of the disclosure philosophy could develop new and improved disclosure techniques. In this way, state securities registration, which now poses a serious regulatory problem, could become the source of considerable public benefit and could make an invaluable contribution to the

---

[82] *See, e.g.*, MOFSKY 73-86.

common effort to achieve maximum investor protection without unreasonably hindering access to the public capital markets or the availability of public investment opportunities.

For example, each state could decide first whether it wished to experiment with the development of its own disclosure techniques, or preferred to accept the federal methods and to concentrate its efforts in other directions, such as rigorous enforcement of its anti-fraud standards. Those states which chose to develop and enforce their own methods of disclosure might devise improved forms of communication of material investment information to prospective investors. Where prospectus delivery is relied upon, both the form and content of the prospectus and the time of its delivery might be the subject of innovation. In addition, other publicity and selling material might be utilized and subjected to supervision to improve the overall quality of disclosure to investors.

Those states strongly disposed to make use of the administrator's evaluation of the merits or risks of securities distributions might conceivably do so under a disclosure system by requiring dissemination of the administrator's opinion as to the merits of the offering to prospective public investors in connection with each distribution. This could be done either by mandatory inclusion of the administrator's opinion in or with the prospectus, or by independent publication or broadcast by the administrator of his view, or both, and this could be done in every case or only in those cases which, in the opinion of the administrator, call for it. Thus, if, in the opinion of the administrator, the proposed securities offering is unjust, unfair, or inequitable, or is hazardous for some specific reasons, that opinion and information could be required to be communicated effectively to all prospective investors. But if the required disclosures were made, the administrator would be denied the power to refuse or restrict access to the public capital markets to any business or industry.

This proposal offers several advantages and represents a new approach to solving the existing regulatory dilemma. By retaining state jurisdiction with respect to securities registration, excessive use of the power of federal preemption is avoided and the states are left free, within the reasonable bounds of federalism, to adopt their own measures to protect their citizens. Also, the states in doing so may make invaluable contributions to the development of improved methods of disclosure and will add their manpower to that of the SEC in the common effort to protect public investors. But by invoking federal preemption of the state merit standard philosophy in favor of a uniform national securities registration policy based on the disclosure philosophy, the real source of the present regulatory dilemma will be removed, and the unreasonable degree of control over access to the public capital markets and over the availability of new investment opportunities which now exists will be eliminated. Although different disclosure requirements in the various states might create the need for different state disclosure documents in addition to the SEC prospectus in a multistate distribution, this scarcely represents the degree of burden on business finance which presently exists under the merit standard philosophy and does not appear likely to create unacceptable hardship.

C. *An Appraisal of Objections to the Proposal*

Inevitably, any proposal which would simultaneously change long-standing traditions in the field, inject a novel proposition for resolution of a continuing debate along essentially moderate lines, and suggest a new challenge for the Federal Securities Code, is likely to meet with opposition. From what has gone before, certain objections can be anticipated and should be briefly discussed.

Is the proposal politically unfeasible? Throughout the continuing debate concerning the existing regulatory dilemma, any proposal for federal preemption of state securities registration requirements has been widely criticized as being politically unfeasible and, thus, impractical. This objection is often coupled with the observation that the SEC is not adequately staffed to undertake the exclusive regulatory role in connection with securities distributions. The present proposal meets these objections in several ways. First, by expressly avoiding full federal preemption of state jurisdiction with respect to securities registration, the present proposal is far less drastic than those for total federal preemption of state regulation. The states would continue to play an important role in investor protection through securities registration requirements, and the states would be left a considerable degree of latitude on their choice of methods in the area of securities registration. They would only be limited by a national regulatory policy based on the disclosure philosophy, rather than the merit standard philosophy, in recognition of the realities of contemporary conditions. This retention of state jurisdiction, and an important degree of state flexibility, should eliminate the most serious political obstacles to the earlier full preemption proposals. It would clearly avoid putting the SEC or the federal securities registration system in the role of the exclusive regulatory authority and system. Therefore, this proposal should not be wholly unfeasible politically, although some opposition may be anticipated. If the proposal is worthwhile, the possibility of some opposition should not deter its consideration at the outset.

A related objection may be anticipated based on the venerable argument in defense of states' rights. The argument that states should be left free to adopt any methods they deem appropriate to protect investors within their borders is best answered by the observation, based on the foregoing analysis, that contemporary American securities and financial markets are thoroughly national and interstate in character, and that under the principles of federalism the right of the states to impose regulation on these markets in the interest of investor protection is subject to reasonable limitation based on paramount national policy. In any event, the present proposal would not totally displace state jurisdiction and authority in the field and, thus, should be able to withstand any criticism based merely on the states' rights argument.

The most serious objection to the present proposal will inevitably come from the defenders of the merit standard philosophy itself, and will be based on the contention that the merit standard philosophy alone is sufficient to deal adequately with the problems of investor protection in public securities distributions. It has already been demonstrated that the central issue in the continuing debate is, in fact, the basic conflict between the disclosure philosophy and the merit standard philosophy. The present proposal would clearly displace the merit standard philosophy in favor of the disclosure philosophy. It is submitted that this issue of policy must be dealt with squarely on its merits, and that the reasons for a decision in favor of the disclosure philosophy have been fully stated.

Finally, the objection may be raised that the important codification project to develop a Federal Securities Code should not become burdened with a potentially controversial issue, reflecting a change in traditional policy, which might endanger the ultimate success of the Code. The initial answer to this objection is that it is premature. Inevitably, and properly, the codification project will attempt significant improvements in the effectiveness of federal securities regulation, particularly where necessary to conform to contemporary conditions in the securities markets and to the needs of contemporary public investors. Professor Loss himself has suggested that the matter of state blue sky law should be reconsidered in the codification project. The present proposal responds to that suggestion; it would clearly not be harmonious with any suggestion that it be coupled with the addition of merit standards to the federal regulation.[83] Precisely the opposite is intended. State jurisdiction should not be preempted, but the merit standard philosophy should be.

As to whether the codification project should undertake the matter at all, one must agree with Professor Loss that "certainly we should not exclude this subject from consideration, because, if there is ever an opportunity to do something about it, this will be it, and surely some rationalization should be possible after thirty-five years or more of joint federal-state regulation."[84] It is submitted that the present proposal offers the best rationalization of the matter, and that it should be attempted. If opposition to this proposal should ultimately become so great as to threaten the success of the Code, which seems unlikely, that situation could better be dealt with then. The mere possibility should not preclude the attempt to deal with one of the oldest problems in American securities regulation, which continues to increase in difficulty and which has yet to be satisfactorily resolved by other means.

IV. Conclusion

State securities registration requirements based on the merit standard philosophy have produced a serious dilemma for interstate financial and securities markets. The parallel federal securities registration has traditionally avoided any preemption of state regulation by express statutory provision, and the problems have, therefore, only increased in complexity with time.

---

[83] *See* Loss, *supra* note 1.
[84] *Id.*

The Uniform Securities Act offered substantial improvement but has been only partially successful because it has been adopted by only some of the states, often with drastic changes, and because, in any event, it retains a modified form of the merit standard philosophy.

On analysis it appears that the root of the difficulties in this area lies in the subjective and discretionary merit standard *philosophy* itself, and not necessarily in state *jurisdiction* with respect to securities registration. The argument for and against federal preemption of the area has been inconclusive and has perhaps been too preoccupied with the issue of jurisdiction. A new approach to the problem is necessary. This new approach would propose that the regulatory dilemma could be satisfactorily resolved if all jurisdictions which impose registration requirements on public securities distributions did so on the basis of the disclosure philosophy, rather than the merit standard philosophy.

Disclosure is arguably the superior method of investor protection with respect to public securities distributions in the modern world and in contemporary national securities markets. In any event the disclosure philosophy is well established as the federal policy with respect to securities registration, which, it is proposed, should be given paramount effect in the interstate securities markets of today. The disclosure philosophy is far less likely to produce inconsistencies and conflicts between concurrent jurisdictions with respect to the same securities offering. The disclosure philosophy is also better suited to meet the real needs of contemporary American investors, and avoids the excessive power in a public official to control or allocate access to the public capital markets among businesses and industries which is implicit in the merit standard philosophy.

It is proposed that the Federal Securities Code should include provisions which would not preempt state *jurisdiction* to impose registration requirements on public securities distributions, but which would preempt the merit standard *philosophy* by declaring the disclosure philosophy to be the paramount national policy applicable to all securities registration requirements imposed on transactions affecting interstate securities markets. Under this proposal all states would still be free to act with diligence to protect investors within their borders and could make a valuable contribution through the development of new disclosure techniques in the area of securities registration. States could not, however, impose discretionary merit standards to control or condition access to the public capital markets or to deny investors the liberty to make their own investment choices. This new approach to the problem should ultimately provide the basis for an adequate resolution of the dilemma created by the existing state securities registration requirements.